

FAIR POLITICAL PRACTICES COMMISSION

Memorandum

To: Chairman Randolph and Commissioners Blair, Downey, Karlan and Knox

From: Jill Stecher, Commission Counsel
John W. Wallace, Assistant General Counsel
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Date: October 2, 2003

Re: Prenotice Discussion of Amendments to Regulation 18707.5
Sources of Income to Owners of Retail Business Entities

I. INTRODUCTION

The conflict-of-interest provisions of the Political Reform Act (the “Act”)¹ prohibit a public official from making, participating in making or using his or her official position to influence a governmental decision in which he or she has a financial interest (section 87100, regulation 18700). An economic interest includes, among other things, a source of income of \$500 or more promised to or received by a public official within 12 months prior to the time a governmental decision is made (section 87103(c)).

Accordingly, a retail customer, who has paid or promised \$500 or more (within 12 months prior to a governmental decision) to a retail business entity in which a public official owns a 10-percent or greater interest, is considered a source of income to the public official. Therefore, if the business owner/public official’s pro rata share of the income from an individual customer of the business equals or exceeds \$500 over the 12-month period preceding his or her participation in a governmental decision, the customer is an economic interest of the official’s.

However, pursuant to section 87103.5, added in 1984, and regulation 18703.5, implementing that section, retail customers of a business are not considered sources of income to a public official owning 10 percent or more of a business entity which engages in retail sales of goods or services to the public, if the retail customers comprise a significant segment of the public generally and the amount of income received by the business entity from the customer is not distinguishable from the amount of income received from the entity’s other retail customers.

¹ Government Code sections 81000 – 91014. Commission regulations appear at Title 2, sections 18109-18997, of the California Code of Regulations.

As amended in 2002, subdivisions (b) and (c) were added to section 87103.5 (Stats. 2002, Ch. 654, attached hereto). The statute now establishes a special, more lenient rule for small jurisdictions. The new provisions define a small jurisdiction as one “with a population of 10,000 or less which is located in a county with 350 or fewer retail businesses.” For a small jurisdiction, the statute also expressly defines that the amount of income received by the retail business entity from a customer is “not distinguishable” from the amount of income received from other retail customers if it does not “exceed one percent of the gross sales revenues that the business entity earned during the 12 months prior to the time the decision is made.” (See section 87103.5(b).)

This regulation is presented for amendment because the 2002 statutory amendments necessitate incorporating the new provisions for small jurisdictions. In addition, staff raises a secondary issue concerning whether regulation 18707.5 should be considered as either Step 3 or Step 7 in the eight-step conflict-of-interest analysis.

II. BACKGROUND

Original Retail Exception

In 1984, the Commission was approached by the League of California Cities (the “League”) to sponsor legislation addressing the source of income issue for retail business owners in small jurisdictions. The League was concerned that owners of retail business entities in small, rural jurisdictions had difficulty serving as public officials because nearly everyone in town was a customer and, consequently, a source of income which could lead to potential disqualification for the public official.

The League proposed that legislation be introduced to create an exception for this situation. The theory was that where the individual customer was not distinguishable from every other customer, the likelihood of favoritism on the basis of being a source of income was substantially reduced.

The Legislature inserted such a provision in one of its bills and the resulting legislation, which addressed this issue, was enacted as Government Code section 87103.5, Income from Retail Sales, as set forth below:

“(a) Notwithstanding subdivision (c) of Section 87103, a retail customer of a business entity engaged in retail sales of goods or services to the public generally is not a source of income to an official who owns a 10-percent or greater interest in the entity if the retail customers of the business entity constitute a significant segment of the public generally, and the amount of income received by the business entity from the customer is not distinguishable from the amount of income received from its other retail customers.” (Added by Stats. 1984, Ch. 931.)

Section 87103.5 sets forth two criteria which must be met in order for a customer of a retail business to be excluded as both an economic interest and possible basis for disqualification to the owner/public official:

- 1) The retail customers of the business entity must constitute a significant segment of the public generally, and
- 2) The amount of income received by the business entity from the customer is not distinguishable from the amount of income received from its other retail customers.² (Section 87103.5(a).)

Section 87103.5 did not define what constitutes a “significant segment of the public generally” or give any guidance as to when income from a customer is considered “not distinguishable” from the amount of income received from other retail customers of the business. This lack of definition and guidelines necessitated the Commission’s adoption of regulation 18703.5 in 1988.³

Former regulation 18703.5 set forth criteria for what constitutes a “significant segment of the public generally.” It also defined a customer of a retail business entity and gave the owner/public official guidelines for “knowing” that a decision will affect a source of income to the retail business entity. Finally, the regulation expressly defined when the amount of income received by a business entity from a retail customer was not distinguishable from the amount of income received from its other retail customers.

III. DISCUSSION

As stated above, last year the Legislature amended section 87103.5 to add a new definition applicable only to retail businesses located in small jurisdictions. In doing so, the addition of section 87103.5(b) defines a small jurisdiction as that with a population of 10,000 or less, which is located in a county with 350 or fewer retail businesses. The criteria under section 87103.5(a), now limited to large jurisdictions, remain unchanged.

Consequently, the current structure of the regulation reflects a two-step process, as follows:

- subdivision (a) sets out the standards for when the retail customers of a business entity constitute a “significant segment” of the public generally, and
- subdivision (b) sets out the standards for when income received from a customer is “not distinguishable” from income from other retail customers.

² Although the statute was not expressly limited to small jurisdictions, the factors were more often met in small jurisdictions.

³ Regulation 18703.5 was renumbered to regulation 18707.5 in 1998.

In an effort to minimize disruption to the line of advice based on this structure, staff has proposed inserting the new “small jurisdiction” rules in a parallel manner. Thus, subdivision (a) still pertains to a “significant segment,” however, it is divided into (a)(1) large jurisdiction provisions and (a)(2) small jurisdiction provisions.

Similarly, subdivision (b) still pertains to when the amount of income is “not distinguishable,” and is divided into (b)(1) large jurisdiction income standards and (b)(2) small jurisdiction income standards.

Regulation 18707.5(a): “Significant Segment”

Subdivision (a)(1)

As noted above, by virtue of the new statutory language dealing specifically with small jurisdictions, regulation 18707.5, subdivisions (a)(1)(A) and (B), now apply only to a “jurisdiction with a population of more than 10,000 or which is located in a county with more than 350 retail businesses.” The new language merely clarifies this standard. This jurisdictional size standard is the opposite of the amended statute’s definition of “small jurisdiction,” as defined in subdivision (a)(2) of the amended regulation.

Subdivision (a)(2)

Proposed regulation 18707.5(a)(2) contains new language that has been added to codify the definition of “significant segment” pursuant to new section 87103.5(b) as applied to a “jurisdiction with a population of 10,000 or less which is located in a county with 350 or fewer retail businesses.”

The test for what constitutes a “significant segment” is identical to the test in subdivision (a)(1)(A), applied to large jurisdictions. However, since the criterion in (a)(1)(B), “[t]hat the retail customers of the business entity during the preceding 12 months number at least ten thousand,” is based on a population that exceeds that of the small jurisdiction, it cannot be used as a test for “significant segment” in subdivision (a)(2) and is not included.

Regulation 18707.5(b): “Indistinguishable Income”

Subdivision (b) of regulation 18707.5 sets forth the standard to determine whether income received from a retail customer is distinguishable from that received from other retail customers. Similar to subdivision (a)(1), identical clarifying language has been added to subdivision (b)(1) that applies to a large jurisdiction “with a population of more than 10,000 or which is located in a county with more than 350 retail businesses.”

Regulation 18707.5(b): Fiscal Year versus 12 Month Period

For large jurisdictions with a population of more than 10,000 or more than 350 retail businesses, proposed subdivision (b)(1), sets forth the standard to determine whether income received from a retail customer is distinguishable from that received from other retail customers, as follows:

“... the amount of income received by a business entity from a retail customer is not distinguishable from the amount of income received from its other retail customers if the amount spent by the customer in question during the preceding 12 months is less than one-tenth of 1 percent of the gross sales revenues of the retail business entity for the preceding *fiscal year*.”⁴ (Emphasis added.)

The amendments to section 87103.5 added a new subdivision (b), which sets forth the size of a small jurisdiction and an income standard specifically for small jurisdictions. Articulated within the statute itself, the income standard is:

“... the amount of income received by the business entity from the customer does not exceed one percent of the gross sales revenues that the business entity earned during the *12 months prior to the time the decision is made*.” (Emphasis added.)

Therefore, this income standard is used for small jurisdictions in proposed subdivision (b)(2) of the regulation.

The second set of bracketed language in regulation 18707.5(b)(1), for large jurisdictions, uses the original percentage of gross sales revenues, but parallels the standard of “12 months prior to the time the decision is made,” rather than using the fiscal year standard.

Decision 1

As noted above, regulation 18707.5(b)(1) currently uses a fiscal year standard for determining the amount spent by a retail customer.

Implementing the statutory change raises the question of *whether there should be two different time standards, one using a fiscal year (applicable to large jurisdictions) and one using 12 months preceding a decision (applicable to small jurisdictions)*. Since the revised statute explicitly sets forth the 12-month standard for small jurisdictions, amending subdivision (b)(1) to use the same 12-month standard for large jurisdictions would be consistent. With this change, the parallel test in subdivisions (b)(1) and (b)(2) now only differs as to the percentage of money spent by

⁴ Note that this standard for income is only articulated in the regulation; it is not set forth in the statute.

the customer over the same measurement of time, i.e., *during the 12 months prior to the time the decision is made.*

The Commission should decide whether the same standard should be used consistently for both subdivisions (b)(1) and (b)(2) of the regulation or if subdivision (b)(1) for large jurisdictions should continue to use the fiscal year standard.

The advantage of using a consistent standard is one factor to consider. The other factor to consider is how businesses report their earnings. Large businesses generally utilize a fiscal year standard for reporting purposes, which the Commission has recognized in its other regulations. For example, regulation 18705.1, which sets forth the materiality standards for economic interests in business entities, utilizes the fiscal year standard throughout the regulation.

Decision 1: Staff Recommendation

Staff recommends that the Commission amend this regulation to reflect the new statutory language for small jurisdictions, as set forth in subdivision (a)(2), lines 12-17, and subdivision (b)(2), lines 12-18.

Staff recommends that the new 12-month standard for small jurisdictions (subdivision (b)(1), lines 10-11) should replace the present fiscal year standard applicable to large jurisdictions (subdivision (b)(1), lines 8-9). Since the statute binds the Commission to use the 12-month standard for small jurisdictions, a consistent approach would be to use the 12-month standard for large jurisdictions, as well.

Staff further recommends that the Commission make other minor changes⁵ and schedule this regulation, as amended, for adoption at its December 2003 meeting.

Secondary Issue

During the staff discussion of the amendments to regulation 18707.5, it was questioned whether regulation 18707.5 should be in Step 3 of the eight-step conflict-of-interest analysis rather than in Step 7. Moving regulation 18707.5 to Step 3 was suggested because if the retail customer meets the criteria in regulation 18707.5, the customer is deemed *not* to be a source of income to the business owner, hence, ending the analysis at Step 3 and eliminating the need to proceed to Step 7.

⁵ Please note that there are two minor changes in regulation 18707.5(c), as follows:
Line 20 contains one grammatical change for clarification.
Line 21 contains conforming subdivision number changes.

By way of background, the Commission adopted regulation 18700 in October of 1998, as part of the conflict-of-interest reorganization and restructuring project. This regulation sets forth an eight-step analysis to determine whether a public official has a disqualifying conflict of interest. The eight steps of the analysis are as follows:

- 1) whether the individual is a public official,
- 2) whether the public official will be making, participating in making, or using or attempting to use his or her official position to influence a government decision,
- 3) identify the public official's economic interests,
- 4) whether the public official's economic interest is directly or indirectly involved in the governmental decision,
- 5) the applicable materiality standard for each economic interest,
- 6) whether it is reasonably foreseeable that the governmental decision will have a material financial effect on each economic interest,
- 7) if the financial effect is distinguishable from the effect on the public generally, and
- 8) if the public official's participation is legally required despite the conflict of interest. (Regulation 18700(b)(1)-(8).)

Therefore, one must usually first go through steps 1-6 of the eight-step analysis, described above, to determine if there is a reasonably foreseeable material financial effect on an economic interest. Under Step 3, an official's economic interests must be identified. These economic interests are described at regulations 18703.1 through 18703.5, inclusive. Satisfying the first six steps of the analysis results in a conflict of interest and a basis for disqualification, unless an exception, such as "public generally," applies.

Under Step 7 of the analysis, the "public generally" exception applies if the financial effect of a decision upon a public official's economic interests is substantially similar to the effect on a significant segment of the public.⁶ This approach is consistent with the longstanding policy of the Commission, which has always interpreted "public generally" as an exception. In addition, under Commission policy, exceptions are construed narrowly.

⁶ Regulation 18707(a), "Public Generally" provides as follows:

"Notwithstanding a determination that the reasonably foreseeable financial effect of a governmental decision on a public official's economic interests is material, a public official does not have a disqualifying conflict of interest in the governmental decision if the governmental decision affects the public official's economic interests in a manner which is indistinguishable from the manner in which the decision will affect the public generally as set forth in Title 2, California Code of Regulations, sections 18707.1-18707.9."

It can be argued that regulation 18707.5 is properly placed in Step 7 because under the eight-step analysis, it is still necessary to identify an official's economic interest, which in this case is income from retail customers, and then determine if a special "public generally" exception applies.

The placement of regulation 18707.5 within the eight-step conflict-of-interest analysis is not explicitly at issue because of the statutory changes in section 87103.5 or the proposed amendments to this regulation. Staff does not recommend changing the placement of this regulation within the eight-step analysis at this time. However, this is an issue staff wanted to bring to the attention of the Commission for its possible future consideration.

Attachments: Section 87103.5
Regulation 18707.5

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